Cash Value Life Insurance in Captives—Why it Makes Too Much Sense

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I've been reading on blogs and "industry" articles quite a bit lately about Cash Value Life (CVL) and its use inside Captive Insurance Companies (CICs).

There are some "experts" who not only think it's a bad idea but state emphatically that CVL should NEVER be used as an investment inside a CIC. I was so put off by what I've been reading that I was moved to write this summary telling readers why the "experts" are wrong.

CICs are powerful risk mitigation and income tax planning tools—if you are not familiar with the power of using CICs for risk mitigation and income tax reduction for business owners, you should learn about them. Businesses can take deductions up to $1.2 million into small 831(b) CICs. For those who can only pay a premium of $100,000 annually, they can use the "affordable" CIC. To view an educational webinar I did on CICs, please click on the following link: http://www.strategicmp.net/page/life/affordablecics.

What have the "experts" been saying about using life insurance in a CIC?—in short, they have been saying that under *no circumstance* should CVL be used in a CIC. When I say used in a CIC, I mean used as an investment to protect and grow the cash surplus of the CIC.

Why are they saying CVL shouldn't be used? Well, my initial response is because they are ignorant "experts" (if there is such a thing), but that's an opinion not a reason.

Their reasons all seem to stem from the abusive-tax transaction doctrines. What are those? The most common ones are 1) Substance over Form; 2) Sham Transaction; 3) Economic Substance; 4) Business Purpose; 5) Step Transactions.

If you go to the *end of this document,* you can read a detailed summary of each doctrine and why I don't think any of them apply to using CVL insurance in a CIC.

In general, however, the biggest flaw of applying any of the above-mentioned abusive-tax doctrines is quite glaring. The pontificators say that a CIC that uses CVL to protect and grow the surplus of the CIC is abusive because it's the *tax deductible purchase of life insurance*.

What the "experts" fail to understand and acknowledge is that a "properly" set up CIC has *absolutely nothing to do with* purchasing CLV. The business is not taking a deduction for the purchase of life insurance. The business is taking a deduction for the *legitimate purchase of Property and Casualty (P&C) insurance* sold to the business using an actually sound determination for the premium paid.

Examples of past tax schemes—the "expert" pontificators use the two tax schemes most in this industry are aware of to illustrate why CICs that use CVL to protect and grow the surplus should also be considered tax schemes. Those two plans are 419 plans (419A(f)6, A(f)5, (e) plans, and VEBAs and 412(i) plans (now known as 412(e)3 plans.

By accident or design, 419 and 412 plans either by law or design invest in life insurance or annuities; and the whole point of the schemes is to purchase life insurance. Heck, 419 plans were known back in the day as "death-benefit" plans which obviously needed to purchase life insurance to provide the stated benefits. Simply put, the *goal was to purchase insurance using deductible dollars*.

The goal with a CIC is to provide P&C insurance— NOT to buy life insurance. Having said that, as you will read, I believe that life insurance is a terrific tool to protect and grow the surplus of the CIC; but the stated *goal/purpose of the CIC has nothing to do with life insurance*.

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Additionally, with both the 412 and 419 plans, the goal was to somehow get the CVL insurance paid for by the business in a tax-deductible manner and out of the plans in a tax-favorable manner (tax discounted or even tax free with some of the most abusive plans).

When a CIC buys CVL with part of the surplus, there is no tax advantageous way to get the policy out of the CIC and to the owners (at least not in a legitimately setup CIC). The surplus of the CIC, including the CVL policy, are treated the same whether they are CDs, money market accounts, tax-free bonds (which are popular investments in a CIC), etc. When the CIC is shut down or terminated (keeping in mind that a CIC is nothing more than a C-Corporation), the assets in the CIC at termination come out and the owner pays long-term capital gains taxes.

To summarize the biggest and fatal flaw of the pontificator is that they think ***any*** CIC that at some point uses CVL to protect and grow the surplus fails the abusive-tax transaction test(s). That defies logic, and the reality is that the vast majority of CICs' setup are done so legitimately for the purposes of risk mitigation for the business. The fact that the business owner who many times owns the CIC shares at some point down the road (12 months, 24 months, 48+ months, etc.) decided that CVL is a good way to protect and grow the surplus illustrates the silliness of a finite statement that ***any*** CIC that uses CVL as part of the surplus is an abusive-tax shelter.

Where are the actual cases?

What's both comical and sad is that the pontificators publishing on this subject have no court cases to point to. In fact, if you read their writings closely, you'll see the words "should" and "likely" used a lot. Why these kinds of words? Because the authors can only make an assertion about what they "think" might happen.

For example, you'll read over and over statements that start out like ….The IRS should... or that it is unlikely that…

I actually don't mind a good-faith attempt to make advisors aware of concepts the IRS may take issue with. However, the conclusionary language of the "experts" is so strong (i.e., that CVL should ***never*** be used in a CIC) that the fact that the author has nothing substantive to point to when making assertions seems to be lost.

Abusive CICs

It is my opinion that we will see court cases come down on abusive-CIC structures using CVL insurance. Anytime there are big life insurance commissions at stake, there will be administrators and insurance agents that will push the envelope. But that does ***NOT*** mean that ***any use*** of CVL in a CIC is, should be, or will be prohibited. It is not currently, and I don't believe it ever will be notwithstanding what the "experts" have to say.

I have seen CIC structures being pitched that I think would fall under the abusive-tax transaction doctrines. They are ones where 100% of the surplus is poured into CVL. Many times this is done within a few months of the CIC receiving the first year's P&C premium.

These CICs are touted to insurance agents as a way to make large life insurance commissions and are sold to clients as a way to buy life insurance in a tax-favorable manner. The goal of the CIC is to sell life insurance— not to provide legitimate P&C coverage to businesses.

If I agree that some CICs will be deemed abusive-tax shams, then why am I disagreeing with the "experts" who say that using CVL insurance in a CIC is a bad idea? Because I do not agree with their finite statement that ***any*** CIC that uses CVL is or will be deemed abusive. In fact, I think it's a good idea to use CVL in the surplus.

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Marketing Materials

If you read the 419 cases that went to court, you'll see a consistent theme the judges focused on. The plans were actually promoted as tax-avoidance plans. The main exhibits the IRS used in the court proceedings were the brochure insurance agents used to sell the plans and guess what else?—the actual life insurance illustrations that many not very bright insurance agents gave to their clients. The illustrations showed the build of cash value but also massive tax-free loans from the life policies.

If there are CIC marketers out there touting in their material that CICs are tax-avoidance vehicles and then show life insurance illustrations with massive loans coming out of them prior to the client making the decision to create a CIC, then I'd agree that these could very well be deemed abusive-tax shelters by the IRS.

Considering that the vast majority of CIC administrators do not pitch them as tax-avoidance plans or show clients life insurance illustrations of any kind, let alone ones that show borrowing, a major tool that is normally used by the IRS when attacking tax schemes won't exist (and, therefore, no presumption should be made that the CIC was created to avoid tax or to purchase life insurance in a tax-advantageous manner).

What about tax-free bonds?

What's additionally pathetic and telling about the attack on the use of CVL as an investment in the surplus of a CIC that you won't hear these same experts say is that the CIC would also be deemed an abusive-tax shelter if tax-free bonds were used to protect and grow the surplus.

Why not? Isn't the argument exactly the same when investing in tax-free bonds (which, by the way, are a very common investment inside a CIC and has been for years)? As such, shouldn't there be articles galore stating that any CIC that takes the surplus and invests in tax-free bonds is an abusive tax shelter?

The fact of the matter is that no such articles exist. Why? My own opinion as to why is because it's a ridiculous assertion to make. It's equally as ridiculous to state that *any* CIC that uses CVL is an abusive-tax shelter because of the problems with 419 and 412 plans back in the day that used life insurance. Unfortunately, because many in our industry are familiar with the past abuses of 419 and 412 plans, when they hear an "expert" state that a CIC with life insurance are just like these past abusive plans, it resonates with that uninformed reader.

Prudent Investor Rule (PIR)—the PIR is a legal doctrine which provides guidance to investment managers regarding the standards for managing an investment portfolio in a "legally" satisfactory manner.

Basically, prudent investing amounts to a process which one follows. If the process followed in making investment decisions is prudent (based on what is known and not known at that time), then the decisions being made are prudent, regardless of subsequent results.

When insurance regulators look at the surplus of a CIC, they will look to see if the surplus is invested in a manner so as to protect them from market crashes (which, in turn, will protect the policyholder by making sure that the CIC stays solvent (or at least so it doesn't become insolvent because of poor investment decisions)).

CIC surplus—a CIC is a real live insurance company. As such, the surplus of the CIC that accumulates needs to be invested in conservative investments so that the money will be around in the event claims are filed. If we apply the prudent-investor standard to investing the CIC surplus, it would not be prudent to invest the surplus in mutual funds, penny stocks, options, etc. To do so is too risky and wouldn't be prudent.

What about Cash Value Life insurance?

Is it prudent to invest in a CVL policy where the cash couldn't go backwards when the market goes negative and when over time the expected rate of return should be significantly higher than fixed return vehicles like CDs and money markets?

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You ***don't need an IQ above 50*** to determine that any investment that can't go backwards when the market declines and should do better than CDs and money market accounts would make for a prudent investment in a CIC (and if you are thinking that CVL is still not prudent because of early high surrender charges, keep in mind that there are many policies with high cash value riders to make this point a non-issue).

So why are some "experts" saying that CVL should NEVER be used as an investment in a CIC?— again, to me its ignorance run amuck; but aside from that blanket statement, I believe it's a misunderstanding of the tax-abuse doctrines (ironic since it's JDs and LLMs making this mistake).

I also wanted to point out that there is a 37-page summary written by a law professor on why CVL insurance should not be used to protect the surplus in a CIC. It's what the authors writing articles are pointing to for their support that CVL shouldn't be used.

I've read the 37-page document very closely. What it reminded me of is the tax opinions hack law firms used to write and give to individual clients back in the heyday of 419 plans. If you didn't know, back in the day, if a law firm wrote a tax opinion stating that a strategy had been reviewed and is given the ok by the law firm, the client after getting busted for the tax scheme would use the legal opinion as a get-out-of-jail free card to use a Monopoly game analogy. The legal opinion was used to get clients out of tax penalties and interest if the IRS ever disallowed the deductions for a tax scheme they were entering into.

These worthless tax opinions all had predetermined outcomes (that the tax scheme the client was entering into was reasonable in the law firm's eye under the state of the law), and they read like a document that didn't have any sense of legal reality.

The 37-page document also reminded me of my uncle's doctoral thesis. He had to write something, so he came up with a hypothesis that to me defied logic. But he manipulated his thesis every which way he could to support his predetermined conclusion. As I stated, the 37-page document was written by a law professor. You may have heard the following saying about professors: "publish or die." Ironically, in his bio section on the law school's website, it says that the professor "has been widely published, placing 16 law review articles at various law schools."

To me, the professor's 37-page document seemed to be an attempt to simply publish something to try to find some relevance for his existence. In doing so, the paper to someone who understands the subject matter seems like a contrived document that is unsuccessful in its attempt to be credible. Like the tax opinions written back in the day about 419 plans, it's like the professor decided the conclusion of the document before writing it and then went out of his way to make every unrealistic argument (although potentially realistic to a lay reader) to justify his predetermined conclusion.

If you would like to read this 37-page document, feel free to e-mail me at roccy@badadvisors.com; and I'd be happy to forward it to you so you can come up with your own conclusion about the credibility of our good professor.

Summary about using CVL insurance in CICs

There is no legitimate argument that can be made for the blanket/finite statement that CVLs can't or shouldn't be used to protect and grow a percentage of the surplus in a CIC. To make such a bold assertion is absurd and hurts/destroys the credibility of anyone making it.

Using the prudent-investor rule, it makes so much sense to use CVL insurance to protect and grow the surplus that I can make a strong argument as to why nearly every CIC should allocate at least 20% of its surplus to a high Cash Value Life insurance policy with its surplus.

Those who are writing articles and quasi-white papers suggesting that CVL should never be used in a CIC are, in my opinion, simply trying to make waves in the CIC industry and get themselves a little press along the way. Well, I'm here to help give them press and to suggest that their assertions are ridiculous and are not based in law or reality.

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Abusive-Tax Transaction Doctrines

1) Substance over Form[i]

The tax doctrine of substance over form is a judicial creation. It is often invoked by the courts in cases in which a taxpayer has *constructed a scheme* of transactional relationships in documents and has a view on tax advantages that flow from tax reporting based on their effect. But tax law requires that there be a relationship between a desired tax benefit [such as a tax deduction, deferral or characterization of income] and an objective that relates to a purpose of business or a profit motive.

If *tax motivation* is seen to *outweigh business purpose* and/or profit objective on the evidence evaluated [documents and factual inferences from analysis of the documents as well as from the actions of the parties to the documents], the courts will more than likely decide that the taxpayer's efforts of "form" do not reflect the "substance" of the undertaking in economic terms. On that basis, the intended tax benefits will be denied. Words such as "masquerade," "a fiction," and similar epithets are often used by the courts to epitomize all manner of complex undertakings which, in the effort to secure valuable tax benefits, failed in operation to reflect a true economic purpose apart from obtaining the tax benefits.

It is also true that the motive of tax avoidance will not be pertinent to analysis of an undertaking carried out in a manner consistent with documents and actions of the taxpayer(s) if the undertaking is seen *to have economic reality* in terms of business purpose and a true expectation of profits. In such situations, the ***ulterior purpose of tax avoidance is disregarded***. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. So, the question for determination is whether the law permits a taxpayer to set up artificial arrangements and devices of form to conceal their real character, which is the accomplishment of a preconceived plan solely to obtain tax benefits. It does not. Courts will not generally uphold tax-advantaged transactions unless the transactions had economic substance and the taxpayers incurred real economic risk. If it were otherwise, taxpayers would be able with impunity to exalt artifice above reality and to deprive tax provisions in question of all serious purpose.

Often, when the intent of the statute is seen by the courts to have been subverted by an artificial arrangement that is solely tax-motivated it will refer to the arrangement as a "sham." There is really little difference in terms between "lack of economic substance," "lack of economic reality," or "sham." The outcome is the same irrespective of the term used to characterize what the tax law proscribes.

Why this doctrine doesn't apply

Let me keep this simple and short. A "properly" setup CIC is done so to provide needed P&C insurance to protect a business from risk that it is currently self-insuring against. A properly setup CIC has absolutely nothing to do with the purchase of life insurance. As such, this doctrine has no application to be used against a CIC owner that at some point decides that it is financially prudent to use CVL to protect and grow the surplus of the CIC.

2) Sham transaction[ii]

When a business transaction or plan does not have as its objective earning a profit, but is performed merely for tax motives, the business faces a potential tax issue with the IRS. The IRS may regard the transaction as a sham transaction — which is a *transaction without economic substance*. Sham transactions may result in civil and criminal tax penalties.

If you read the underlined section in the previous paragraph, you should, by now, be able to figure out why this doctrine has no place in a discussion about CIC using life insurance to protect and grow the surplus.

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Why this doctrine doesn't apply

Like 1) above, a "properly" setup CIC is done so to provide needed P&C insurance to protect a business from risk that it is currently self-insuring against. A properly setup CIC has absolutely nothing to do with the purchase of life insurance. As such, this doctrine has no application to be used against a CIC owner that at some point decides that it is financially prudent to use CVL to protect and grow the surplus of the CIC.

3) Economic Substance Doctrine[iii]

Congress codified the common law doctrine of "economic substance" as a mandatory two-prong test in the Health Care and Education Affordability Reconciliation Act of 2010 (H.R. 4872, P.L. 11-152, the "Act") signed into law by the president on March 30, 2010. The "economic substance" doctrine [otherwise stated as the doctrine of substance over form] has historically denied federal income tax benefits to transactions that do not have "economic substance." A *transaction or series of transactions entered into solely or predominantly for tax considerations* normally, that is with very few if any exceptions, lack economic substance if profit [in the sense of a reasonable inference of "business purpose" from all the facts] is not likely without regard to the tax considerations. Thus, even though a transaction or series of transactions may literally comply with provisions of the Internal Revenue Code and its interpretations [the usual "hook" for the "sale" of a transaction scheme or package of planned transactions], the literal compliance, or "form" in which the transaction or series of transactions is "clothed," may not comport with the "substance" or economic reality of the whole.

The Act (§1409) adds §7701(0) to the Internal Revenue Code to provide that a transaction would only have economic substance if (1) the transaction changes the taxpayer's economic position in a meaningful way (considered apart from federal income tax effects) and (2) the taxpayer has a substantial purpose (again, apart from federal income tax effects) for entering into the transaction. This is referred to as a "conjunctive test." It applies to transactions entered into after March 30, 2010.

If a transaction is held together by the mortar of tax considerations and the bricks are the business considerations, the transaction will usually be sound for tax purposes. On the other hand, if the bricks of the transaction or model of the business plan are purely driven tax considerations, the hoped for tax result will inevitably fail. The new Act adds considerable wrinkles to figuring out pre-tax and post-tax economic profit (with fees and other transaction expenses taken into account as expenses) in the "weighting" of "profit potential."

Why this doctrine doesn't apply

Like the other doctrines, a "properly" setup CIC is done so to provide needed P&C insurance to protect a business from risk that it is currently self-insuring against. As such, the transaction oozes economic substance and, therefore, this doctrine has no application to be used against a CIC owner that at some point decides that it is financially prudent to use CVL to protect and grow the surplus of the CIC.

3) Business Purpose[iv]

The business purpose doctrine is a tax-related doctrine. This principle states that a transaction must serve a bona fide business purpose to qualify for beneficial tax treatment. If the transaction has no substantial business purpose other than the avoidance or reduction of tax, the tax law will not regard the transaction. The business purpose doctrine was established by Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 56 (1935) aff'g, 69 F.2d 809 (2d Cir. 1934).

The business purpose doctrine of Gregory applies to different situations which arise under the tax statutes. It plays the role of a constant reminder which states that business transactions must have some purpose other than the mere avoidance of taxes. [Mel Dar Corp. v. Commissioner, 309 F.2d 525 (9th Cir. 1962)].

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Why this doctrine doesn't apply

Like the other doctrines, a "properly" setup CIC is done so to provide needed P&C insurance to protect a business from risk that it is currently self-insuring against. As such, it would be difficult to argue that the transaction wasn't set up for a business purpose. The main reason the CIC was set up in the first place was to help a business protect against uninsured risks. As such, this doctrine has no application to be used against a CIC owner who at some point decides that it is financially prudent to use CVL to protect and grow the surplus of the CIC.

5) Step transactions[v]

The step-transaction doctrine is a principle applicable to taxation laws. According to this principle, effect should be given to the substance, rather than the form of a transaction, by ignoring for tax purposes steps of an integrated transaction that when taken separately are without substance. In short, the tax liability should be determined by viewing the transaction as a whole, disregarding one or more non-substantive, intervening transactions taken to achieve the final result. This doctrine expresses the familiar principle that, in applying the income tax laws, the substance rather than the form of the transaction is controlling. The U.S. Supreme Court has expressly sanctioned the step-transaction doctrine in many cases, noting that interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.

Courts generally enunciate three basic tests that define the criteria upon which application of the step-transaction doctrine applies--the interdependence test, the end-result test, and the binding-commitment test. The interdependence test requires an inquiry as to whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. The end-result test examines whether it appears that separate transactions were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. The binding-commitment test examines whether there was a binding commitment to undertake the later step in a series of transactions.[Falconwood Corp. v. United States, 422 F.3d 1339 (Fed. Cir. 2005)] .

Why this doctrine doesn't apply

I included the step-transaction doctrine because it's one that many are familiar with, but it's the least likely to have any use when talking about CICs and CVL.

To set up a CIC is not a simple process. You have to set up the CIC, use an underwriter to underwrite the risk, there is risk sharing which is a vital component, and the list goes on from there. These are all interrelated steps that are necessary to set up, run, and be able to take a legitimate deduction for the P&C premium paid by a business to the CIC.

Step transactions usually come into play when you have steps that are allowed in the tax code that normally are not pieced together but have been for the sole purpose of avoiding taxes. To suggest that someone went through the many legitimate steps to setup and pay premiums to a CIC (a CIC that provided market value P&C insurance to the business) so the CIC could use a portion or the surplus to fund CVL is truly ridiculous.

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[i] http://www.taxrisk.com/Articles/Doctrines-of-Substance-Over-Form-Economic-Substance-Economic-Reality-Business-Purpose-and-Sham-Transactions.shtml

[ii] http://www.taxrisk.com/Criminal-Tax-Defense-Prosecutions/Tax-Abuses-Information.shtml

[iii] http://www.taxrisk.com/Criminal-Tax-Defense-Prosecutions/Tax-Abuses-Information.shtml

[iv] http://definitions.uslegal.com/b/business-purpose-doctrine/

[v] http://definitions.uslegal.com/s/step-transaction-doctrine/

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